CONVERTIBLE BONDS AND STOCKS

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In concise language, a convertible security is a bond, stock or note which at the option of the holder, is exchangeable under certain conditions and at some time—present or future—for some other security issued—usually, but not always—by the same corporation. It has frequently the usual characteristics of a debenture bond; that is, an ordinary promissory note of the issuing company, but nearly as many issues are secured by first mortgages upon all or parts of the properties. Where the form is that of the ordinary debenture, it does not carry the features of a well-secured bond in case of a default, although it does rank ahead of the preferred stocks in its claim upon the earnings and assets. But where it is a direct first-mortgage obligation, covering all the company's property, it becomes the safest security such a corporation can give. A convertible bond has been characterized as a "call" upon the prosperity of the company, and thus upon that of the country.

An interesting feature pertaining to these securities is that the investor seems ready to purchase them at prices which indicate a willingness to forego some degree of immediate value for the sake of expected future increment.

It is difficult to frame any fixed definition that will embrace all the convertible issues, for the variety of securities that have been given the convertible privilege and likewise, the variety into which they are convertible, is very diversified. The privileges of conversion differ still more widely, there being but few issues which even approximately coincide in this latter regard. Bonds which are convertible into stock predominate over any other class; following which, there is but little to choose between notes convertible into bonds, and one class of stock convertible into another. The face value of what may be termed "live issues" of American corporations, carrying this exchange privilege, is the rather startling total of over one billion five hundred millions of dollars.

In the brevity of language which the banker is prone to adopt, these securities are called "convertibles," which term we shall find convenient to use occasionally in referring to them as a class.

To say that there are fashions in the investment world is not, perhaps, a fair way to express it. Expedients may be the better word; but that investment selections go in waves that may well be likened to the changes in fashions is a fact well known to all bankers. It is not likely to be disputed that swings of the pendulum toward this or that temporarily popular security are almost inevitably followed by too far a deviation from the perpendicular line of conservatism, ending with an overdoing of the frenzy, and resulting, sometimes, in almost incalculable losses, and not infrequently in general financial collapse. This has all been tested out in the world of finance, by the issuing of farm mortgages, or debentures based upon them as collateral, resulting in widespread disaster in the early 90's. In the railroad world, in particular, unsatisfactory conditions arose from the unwise issuing of income, debenture and collateral trust securities.

It must not be supposed that the extraordinary privileges so often accompanying convertible issues have been conferred out of pure altruism, because in many instances they have been justified upon economic grounds. Culminating with the experience referred to in the last paragraph and many others of a similar nature, corporations were sorely beset some years ago for a means of further financing their much-needed development work. The condition of mind of the investment public was such that an added zest of some nature was almost imperative, and the general issuing of convertible securities was the saving expedient which was generally and successfully adopted. Speculation was also running riot at the time, and the railroads appreciated the value of the speculative feature which the convertible plan offered. Therefore there was a rapidly increasing flood of these securities, the popularity of which has not yet begun to wane.

The fact that railroads of such high standing as the Baltimore and Ohio, Union Pacific and Pennsylvania, by blazing the way with issues of fifteen million, one hundred million and fifty million, respectively, set their seal of approval upon the general adoption of the convertible feature as a way of inducing an already security satiated public to make further purchases, was one means of opening

the flood gates to convertible issues. The average investor naturally inferred that such a plan of financiering must be sound, and so the ways were made easier for corporations of lesser standing to follow the tendency of the times. It was an opportune moment for the public to absorb these securities, because convertible bonds are likely to demonstrate their speculative attractiveness during a period of rapid expansion. Although the foregoing are the principal reasons for the readoption—the idea is not a new one—of this scheme of finance, yet there are others which should be mentioned:

Some companies had in mind the reduction of their fixed interest charges, which an ultimate conversion into stock would bring about. At other times, the issuing of convertibles in lieu of stock has not been based upon the best interests from the company's financial standpoint, but rather to retain control of the stock, which control might have been jeopardized by an increased issue of the latter. That is to say, unless those in control felt disposed, and were financially able, to go into the market and purchase enough of the new issue to retain control, they could avoid all this by issuing a convertible bond, the convertibility of which could not be effected until some time well into the future. The issuing of a bond convertible at some future time into stock is nothing more nor less than the present sale of future stock, but the voting privilege would not accrue until after conversion. The fact that others were anxiously awaiting the opportunity to obtain control in the open market only increased the desire for this means of self-preservation.

There have been many instances where railroads could not place their new issues of stock at anything like par, and also could not have sold plain bonds—debentures—bearing a low rate of interest, except at a prohibitive discount. But by issuing a bond bearing a rate of interest commensurate with the times, and carrying with it a chance to share in any future advance in the stock beyond the conversion price, successful financiering has been accomplished, which, otherwise, might have been impossible.

To many, unfamiliar with the financial history of thirty or forty years ago, it may seem that the sudden outpouring of convertibles during the past ten years has been the first pioneering under that plan. But not so; the beginning dates long before that, for we find an issue of this character back in the days of Commodore Vanderbilt who at the time of his interest in the Erie, caused that

railroad to issue, in 1868, ten millions in convertible bonds, to secure funds for double tracking. Perhaps the next important issue was in 1875, when railroad bonds were not so highly esteemed by investors as in more recent days, at which time the Chicago, Milwaukee and St. Paul Railroad Company issued thirty-five millions of dollars in seven per cent. bonds; and in 1878 put out another issue, at the same rate, on the Iowa and Dakota extension. Then there were issues by such corporations as the Burlington and Missouri River, the Eastern in Massachusetts, and many others. There was, therefore, a period quite remote from the recent large offering of convertibles when to a considerable extent, recourse was had to the same idea.

Referring again to the first St. Paul issue, it will be noted that it was brought out comparatively soon after the disastrous year of '73, so well known to financial history. The section tributary to the road was in the early stages of development and therefore the convertible feature did not offer such reasonable surety of future enhancement, as appears to be the accompaniment nowadays of so many issues of this nature. It was a far different proposition to market a six per cent. convertible bond in 1908 on such a property as the New York, New Haven and Hartford Railroad, with the stock declaring eight per cent. in yearly dividends, to the placing of a similar obligation, in 1875, backed by a railroad property in the undeveloped West. It called for more faith on the part of the buyer in the latter instance, and there was a better excuse on the part of the railroad company for adopting the principle. But, nevertheless, it is reported that a St. Paul director argued that there was an injustice to the stockholders, since the bondholders had not only a reasonable assurance of their interest, in good times or bad, but, in addition thereto, the privilege of sharing in the stockholders' profits if the stock increased sufficiently in value. That reasoning is applicable to all such issues.

This same idea that the bondholder has everything to gain and probably little to lose, by purchasing a convertible bond in preference to stock of the same corporation, sums up much of the good and the bad of this whole scheme. It is, the writer believes, frequently an injustice to the stockholder; not always a benefit to the corporation, besides generally proving too great a prize to have given the bondholder. The plan is not always, however, injurious to the

stockholder, for there are times when if, instead of issuing convertibles, the capital stock should be largely increased, it might depress the value of the existing stock to a point entailing a hardship upon the holders, whereas the placing of an issue of convertible bonds, especially where the convertible privilege does not begin to operate until some distant date, may not only enable the company to finance itself at a temporary lower rate of interest than the dividend rate upon its stock, but the fixed charge accompanying the convertible issue would, when the conversion privilege begins to operate, gradually decrease and possibly eventually disappear entirely. The slow conversion into stock of such an issue would not be apt to act seriously to the disadvantage of the other stock outstanding, and thus the holders would not suffer.

In all this discussion, where it may be considered a disadvantage to the existing stockholders, we are going upon the assumption that the stock is at the time selling at more or less at a premium, and paying dividends in excess of the average normal fixed charge upon bonds.

Enormous profits have been made on convertible securities, and, withal, as a class, up to the present time, the purchasers have been wonderfully well remunerated upon their investments; although, in some cases, profits have been in reach, which were unwittingly allowed to escape. The possibility that this may occur demands vigilance at times on the part of investors in convertibles, all of which the following illustration will make clear: At the time the Chicago, Milwaukee and St. Paul Railroad Company's convertible 7's, previously referred to, approached maturity, they were worth about 170, if converted. It is remarkable how many failed to realize this, and, consequently, turned in their bonds for redemption at par and interest, thus losing a certain profit of seventy per cent.

The convertible method sometimes has a peculiar effect upon the market value of a stock. We will imagine that the conversion period has been reached, and that the stock has advanced to a point where there is a decided profit to be obtained by converting the bonds and selling the stock received in return. This may bring about such a flood of conversion, and consequent offering of stock upon the market, that its price will be materially depressed.

Another deterring influence, which an issue of convertible bonds may exercise upon an otherwise probable advance in price of a

company's already existing stock, is better explained by an illustration. The Pennsylvania Railroad Company has outstanding a large amount of three and one-half per cent. bonds, convertible into stock paying dividends much in excess of that rate. Thus, as the bonds are converted, the stock issue may be largely increased, drawing more heavily upon the profits, the dividend rate being nearly double that of the fixed charge. It is believed that this factor has been a hindrance to the rise in value of a stock, for which there otherwise seems no very good reason for its remaining below the comparative price level of other securities.

No one questions the public appreciation of these investments at the moment. Their popularity is, of course, due to the ingenious combination of safety and speculation with which they have been surrounded. The purchaser of a security of this class, when backed by a strong and prosperous corporation, has good reason to feel sure of the repayment of his interest and principal, for, surely, he understands that they both rank ahead of any claims of the stockholders, either for assets or dividends. But, besides this, if, during the period when conversion may be affected, there chances to be an enhancement in the market price of the stock into which the bonds are convertible, and to a point well above the exchangeable price, the bondholder will reap a proportionate good fortune. In actual practice, it will not be necessary to effect conversion in order to realize this profit, for the bonds follow fairly closely the fluctuations of the stock, so may be sold and the profit taken. This accounts for the seemingly unreasonably high quotations which are occasionally to be met with for some convertibles. It hardly appears consistent for a six per cent. bond, the obligation of a comparatively new mining company, to be priced in the market at 180, paying less than one per cent. yearly income—an unheard-of low rate of interest for a long-time investment—and yet such instances are to be encountered. The selling price of the stock into which the bonds could be converted was such as to warrant a speculative rise in the price of the latter, far above their investment value.

It is not unusual for a security into which some other may be converted to be quoted so much below the conversion price that no immediate value is attached to the privilege. Under such circumstances, the value of the convertible must be judged from the investment standpoint only. Such a condition was well illustrated

at the time of the money market disturbance of 1907-08, when many issues of convertible bonds maintained a consistent level commensurate with market conditions and prices of other junior issues of the same corporations or other first-mortgage issues of similar worth not having the conversion right. The convertibles were not affected by a fall in the market values of the stocks for which they were exchangeable, even although the latter declined far below the converting points.

No better illustration of the argument of the last two paragraphs can be cited than the action of the Union Pacific Railroad Company four per cent. convertible bonds, during the panic—so-called—referred to, when the common stock fell to the low point of 100, which is seventy-five per cent. below the conversion price of the bonds. A sympathetic action on the part of the latter would have caused their decline to 57.14, a price not at all consistent with their real value. As a matter of history, they at no time fell below 78¼ ("flat").

It will be apparent that the price action of convertibles will be sympathetic with the securities into which conversion may be effected only as the quotations of the latter exceed the exchangeable prices; and that they do not fall to a point beneath the same merely on account of such decline. There must be other factors existing, such as a disturbed money market, an impending trouble likely to affect the particular company, or the like.

There are so many things, in connection with convertibles, which call for intelligent thought—and forethought—so that the holders of these investments may receive the maximum benefits obtainable therefrom, that a few of the more salient features will be enumerated.

One important consideration is that of a bond, to illustrate, exchangeable at par for a given stock at 140. When the two securities are quoted at these respective prices, accrued interest and dividends disregarded, they are on a conversion equality, and nothing is to be gained by converting. If the stock advances, and the bonds remain stationary, conversion becomes profitable. But—and this is the point—suppose the stock remains stationary, and the bonds fall below par, conversion is, likewise, profitable. If the bonds are selling at ninety-five, the conversion equality of the stock falls to one hundred and thirty-three, so, if the latter is quoted

above that figure, it behooves one to convert, or to buy bonds and exchange for stock, if the prices are far enough apart to pay commissions.

So far, we have made no particular distinction between issues in which the conversion privilege is already operative and those where it becomes effective at some future date. But there is a marked difference in the price action upon the two classes to be converted. Under the latter conditions, the sympathetic price control of the stock upon the bonds is less marked the more distant the conversion period happens to begin. If not until ten or a dozen years, the price of the stock, however much above its exchangeable value, will but little influence that of the bonds; the latter following more their strictly investment value. But, as the time shortens, the effect increases, until the conversion period begins, when the price of the two securities, if that of the stock is at or above the converting point, must come together. As the conditions of convertibility approach fulfillment, public interest naturally increases, consequently giving a greater impetus to market activity.

It not infrequently happens, however, when the conversion period is comparatively near, say three years or less, that the bonds may be purchased at prices not in keeping with a reasonably sure estimate of their future conversion value. Let us take the General Electric five per cent. convertibles, which can not be exchanged for stock before June 1, 1911; then on a basis of par for par. The stock is paying eight per cent. yearly dividends, whereas the bonds pay five. Valuing each on the basis of irredeemable securities—which is the only true way under the circumstances—we find that at the present (say, as of March 1, 1910) market value of the same—142 for the bonds and 156 for the stock, and taking the stock as of a "flat" price—the latter pays about 5.13 per cent., and the former 3.52 per cent. yearly income, a difference of 1.61 per cent. From the time of computation to the date when conversion may begin (one year and three months) this would equal, to use even figures, two per cent. Consequently, the holder of the stock would be that much better off in interest return than the bondholder. The market difference in the prices, however, is fourteen per cent. Deducting the two per cent., there appears to be an inconsistency of twelve per cent. in the market quotations in favor of the bonds.

Under this state of affairs, it would appear logical for the holder

of the stock to sell the same and purchase bonds, providing, of course, it was, and is, his intention to retain his investment until the date of conversion, when, everything else being equal, the price of the two securities must become practically identical. The weakness in the deduction is that the bonds would not participate in any extra cash or stock dividends which might be declared upon the shares in the meantime. Accepting this as an improbability, and further basing one's faith that the eight per cent. dividend rate will not be reduced, there must be an actual profit of twelve per cent., based upon the foregoing quotations, by changing from stock to bonds, which may be obtained by patiently waiting fifteen months, in addition to an interest return of 5.13 per cent. upon the money invested. It is also clear that if it is safe to predict a quotation for the stock on June 1, 1911, equal to or higher than 156, the same profit is to be had by buying the bonds now rather than the stock.

We have just mentioned that the only true way to value a bond such as that under discussion, is as an irredeemable security. It is taken for granted that the reader will differentiate between the use of bond value tables for determining the yield from redeemable securities, and that of stock tables for those running in perpetuity. Some controversy has arisen as to how to treat convertible bonds from the "return upon the investment" standpoint. The circumstances surrounding the various issues inject different conditions into the argument. Take, for example, the convertible bonds of the International Steam Pump Company, which, some time before being called for redemption, were selling at about 102, with the stock into which they were convertible quoted at only 48. As the conversion parity was 100, it is obvious that there was no profit to the holder in converting at that time, and, judging from the past and from the fact that the bonds matured in less than four years, none of them was likely to be converted.

There appears to be but one way to value a security under these conditions, from the income standpoint, and that is by the net return, pure and simple, as obtained from ordinary bond value tables; that is to say, a six per cent. bond having approximately four years to run, selling at about 102, would return annually, say five and three-eighths per cent.

On the other hand, turn to the Union Pacific Railroad Company's convertible 4's, quoted at 110, and its first mortgage 4's,

quoted at 101. There must be some reason for the difference in these prices, especially when the better secured bond is offered at a materially lower price than the inferior one. If, therefore, the first mortgage bonds are selling upon an investment basis, the convertibles must necessarily be selling well above their actual investment value. In this latter case, it seems proper to assume that conversion into stock will sometime be effected; therefore, the bonds should be regarded as a non-maturing stock investment. It must be this way, because the whole argument is based upon conversion eventually taking place, and the bond thus giving way to an irredeemable stock. It makes a great difference whether the net yield of a four per cent. convertible bond selling at 110 be determined upon the basis of its having a definite maturity, and thus using the ordinary tables of bond values—which take into consideration a sinking fund to liquidate the premium paid—or whether the same is to be permanently exchanged for a stock, netting, at the conversion price, considerably better than five per cent. per annum.

From all this, it is not difficult to arrive at the natural conclusion that, where the stock of a property is selling above the conversion price, and paying dividends at a rate likely to be maintained, the convertible bonds exchangeable therefor should be valued by the use of stock tables; but where the stock for which a bond may be exchanged is selling at a point below the conversion price, and there seems no probability of its advancing beyond that price during the conversion period of the bond, the latter must be valued by bond value tables only; that is, treated as redeemable.

Corporations have been somewhat embarrassed in the issuing of convertible bonds, owing to the fact that it gave the holders a certain call upon the stock not enjoyed by the shareholders of the company. The general common law rule is that, in case of any new stock issues, the old stockholders shall be entitled to have the first opportunity to subscribe to the same, in proportion to their holdings, and at a price as favorable as that given to anybody else. In order to get around this point, certain legislation has been enacted in New York and a few other states, for the benefit of some companies incorporated therein, which desired to issue convertible bonds; but when an attempt was made by a company incorporated under New Jersey laws, to exercise the convertible plan, in the absence of existing legal permission so to do, trouble was encountered, for in the case of

"Wall *vs.* Utah Copper Company," the court decided that the stockholder could prevent such an issue of stock and bonds, unless his proportional share of the stock had first been offered to him.

Although the court did not decide that the stock or bonds were invalidated after they had actually been issued without protest from the stockholders, it did give a decision of which the following is part, and applicable to this discussion:

"A stockholder prior to the increase (in stock) has a right to a voice in the management, and to a share of the assets of the corporation, on final dissolution, in the proportion that his holdings bear to the entire outstanding capital. These rights are materially affected by an increase of the capital stock, and such increase must, therefore, be made in a manner to enable him to become a purchaser of such a proportion of the increased capital stock as will preserve his rights to the same proportion in the assets on final liquidation as he originally had, and also the same voice in the management of the corporation. Moreover, the immediate effect of an increase in the capital stock of a corporation, the value of which is above par, would be to depreciate the value of the original stock, unless the new capital is issued and sold at a valuation equal to that of the original issue. It is, therefore, manifest that if the holders of the original stock are not to purchase the entire new issue, it is to their interests that the increase of stock be issued, not at par, but at what will be its actual value, as near as the same may be ascertained."

Where a bond is convertible into stock, and the latter is paying dividends—no conversion would be likely to take place otherwise—it is the almost universal rule that the company will, at the time of conversion, allow the holder the accrued interest upon the bond, and charge against him the accrued dividend on the stock, at the current dividend rate, the difference to be paid in cash by one party to the other. Sometimes the dividend and coupon dates coincide, so that no cash adjustment is necessary, providing conversion may be accomplished only upon such dates. If the dates agree, and likewise the interest and dividend rates, no adjustment is required, whenever the conversion. Companies differ, however, as to fixing the time from which to compute the dividend; some from the date when the last dividend was paid; others from when it was declared, and so on. These points should always be made sure of. The "current rate" may also need defining.

This agreement as to a cash adjustment of the interest and dividend may appear in the trust deed—if any—in the face of the bond, in printed circulars of the companies, or may be verbal instructions to the ones authorized to effect the conversion, such as trust companies.

Where the conversion price of the stock does not permit of an even division into the face value of the bond, there will be a fractional share to be adjusted. If a one-thousand-dollar bond is exchangeable for stock at two hundred, we should have no such fraction, for five even shares would be received by the one converting; but if exchangeable for stock at one hundred and forty, seven and one-eighth shares would be the approximate number.

The settlement for this fractional share may be worked out in various ways, either by the company paying for it in cash, or by issuing convertible bond "scrip," so-called, which may be exchanged for stock, when presented in aggregate amounts equal to the conversion price of full shares. Some companies provide, however, that if it is not presented in just even amounts, other "scrip" will again be given for the excess, which is by far more equitable. The idea of giving either cash or "scrip" is simply to adjust the one fractional share, whatever the amount of bonds may be that is turned in at a single conversion. That is to say, neither of these methods of adjustment would permit of a cash or "scrip" payment equal to or in excess of the conversion price of one share of stock; the intention is always to give the maximum number of shares for which the par value of the bonds calls, adjusting the difference as above. No better chance illustration could be cited than that of the American Telephone and Telegraph Company. In the conversion of a one-thousand-dollar bond, seven shares of stock and sixty-three dollars and forty-eight cents cash are given; but if forty-four thousand dollars in bonds are converted, three hundred and twenty-nine shares in stock and only forty cents in cash is the method of settlement.

When the adjustment is made in "scrip," the price of the "scrip" should naturally fluctuate in the market with the stock, based upon its proportional amount to the conversion price of a full share of such stock.

Some companies will only give stock in exchange for bonds when presented in amounts evenly divisible by the conversion price of a share. That is to say, in such an event fourteen thousand dol-

lars in bonds would have to be presented for a conversion into stock at one hundred and forty, unless bonds were in denominations of less than one thousand dollars.

Also of great importance is the time when conversion may be accomplished. Often this privilege begins when the bonds are issued, and terminates only with their maturity or redemption. Again, it is set forward to some future date, and then exists for a limited period and so on. Ignorance upon this point has caused the loss of many substantial profits, which, otherwise, would have accrued to the holders.

It is not uncommon for the convertible right to be conferred upon an issue as an afterthought, neither the bonds nor the original trust deed showing any evidence of this privilege, the matter being covered in a supplemental agreement.

Potential added security is sometimes given a convertible debenture both for the better protection of the holder and easier marketability of the issue. It is a proviso inserted that in the event of any mortgage indebtedness afterward being placed upon the property of the company, such mortgage shall likewise include the debenture issue in question.

There are but few convertible bond issues which do not carry a right of redemption prior to maturity. This is a matter that must not be lightly regarded, for a valuable conversion privilege may be lost to the holder on account thereof; or a bond which could be sold at a high premium, because of its value for conversion, may be called for payment at par or a small premium, and, unless the notice of call is discovered in time, the right to convert will lapse. As a rule, conversion may be effected up to, or about, the date named, for payment when a bond is called for redemption, or to within thirty days of such date. The right to redeem is very largely limited to interest dates, and after notice published in papers of general circulation in one or more named cities.

To be forewarned may be preventive of loss, for many possible profits have been allowed to pass beyond recall through ignorance of the conditions surrounding some particular issue. A registered bond generally safeguards the holder in the foregoing respects, as almost all trust deeds provide that a notice of intention to redeem must be mailed to every registered holder affected.

In summing up, convertible securities combine elements of

safety together with a very possible speculative profit, which, if the other usual safeguards in selecting investments are exercised, recommend them to one's serious consideration. The argument is largely in favor of the convertible attachment, everything else being equal, so far as it is likely to profit the investor. He may retain his position as creditor, to which he is entitled as a bondholder, so long as the success of the enterprise, from the stockholder's point of view, is in doubt, and can then change from the position of a creditor to that of a shareholder, and thus part owner, when he becomes satisfied that all is going well, and profits likely to increase in accordance therewith. The essence of all this has been well put by a financial writer after this manner: "Convertibility is a kind of premium which is put on the future, but which relieves the lender of capital from assuming any of what might be called the marginal risks of growth."